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No. 94-1796

IN THE
Supreme Court of the United States
OCTOBER TERM, 1995

ALBERTSON'S, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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REPLY BRIEF

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REPLY BRIEF

In opposing the grant of certiorari, respondent does not dispute the importance of this case. Instead, she argues that the questions presented were correctly decided by the Ninth Circuit and thus need not be considered by this Court. Whether the decision below was correct, however, is a matter that the Court can only determine upon plenary review. Such review should be granted and the decision below reversed, for respondent's arguments on the merits, as the Court will find, are insubstantial.

1. *Section 404 does not bar the current deduction of accrued interest under a nonqualified deferred compensation plan.* The first question presented "affects just about every nonqualified deferred compensation plan in the country." Tom Herman, *U.S. Appeals Court Overturns its Ruling in High-Stakes Tax Case*, Wall St. J., Dec. 6, 1994, at B12. Respondent herself has conceded that because "more than 60% of the Fortune 500 utilize non-

qualified deferred compensation plans . . . [and] [t]he use of such plans is not limited to major corporations," this question "is one of exceptional importance to the administration of the federal income tax laws" and the case is one "of major fiscal importance." App. H at 101a, 102a.

a. Respondent now suggests that the case's "dramatic fiscal implications" derived only from the Ninth Circuit's initial decision, which she describes as a "departure from the status quo." Br. in Opp. 21. Respondent claims that the court's subsequent decision on rehearing "preserves the reasonable expectations of both Congress and taxpayers." *Id.* Respondent has it backwards. In all of the long legislative history of section 404 and its statutory predecessors, respondent is unable to point to even a single instance, and petitioner has found none, in which Congress, a Congressional committee, or even an individual Congressman has stated that the current deduction of accrued interest is barred. Taxpayers themselves, reading the plain language of the statute, reasonably understood that a current deduction is allowed. Even the Ninth Circuit acknowledged that a current deduction would be allowed under "the literal wording of the statute." App. A at 18a.

The status quo, as reflected in Commerce Clearing House's Standard Federal Tax Reporter since 1977, was the widely accepted view that section 404 does *not* bar the current deduction of accrued interest. *See* Pet. 20. As respondent implies, Br. in Opp. 14-15 n.6, petitioner was less alert than some other taxpayers to the availability of this deduction. *See e.g.*, Brief of *Amici Curiae* Connecticut Mutual Life Insurance Company *et al.* (*amici* "have long been deducting when accrued the interest credited under their elective deferred compensation arrangements"). But in 1982, when petitioner did request permission to change its method of accounting to claim the deduction, the Internal Revenue Service granted permission with alacrity. App. C at 45a.

This case arose only because "[i]n 1987, the IRS changed its policy." App. A at 3a. It was that change in respondent's policy, and the Ninth Circuit's own about-face on rehearing, that marked a radical departure from the status quo. As a result, the decision on rehearing now threatens to throw billions of taxpayer dollars—at least $7 billion according to respondent, App. H at 101a—into the tax litigation maelstrom. This Court should grant review to short-circuit that process.

b. As her principal reason why review should be denied, respondent argues that irrespective of the scope of section 404, the amounts petitioner seeks to deduct do not constitute "interest . . . on indebtedness" within the meaning of section 163. Br. in Opp. 11-15. That argument was accepted as the basis for decision in the Tax Court, but it was rejected not only by nine members of that court (four concurring and five dissenting judges) but also by all three members of the appellate panel. In its initial opinion, the Ninth Circuit explained at length and in detail why the amounts do indeed constitute "interest . . . on indebtedness" under section 163. *See* App. B at 29a-32a. On rehearing, the court did not deviate from that position, instead taking pains to disassociate itself from "the reasons upon which the Tax Court majority relied." App. A at 7a. Based upon its own (and respondent's) unsupported notion of what constitutes appropriate tax policy under section 404, the Ninth Circuit on rehearing reasoned that although "under a literal reading of the statutory language, the deduction of *interest* is not affected by section 404," *id.* at 16a (emphasis added), "Congress could not have intended to exclude *interest* payments . . . from the rule prohibiting deductions until such time as the employee receives the benefits." *Id.* at 18a (emphasis added). The court obviously rejected respondent's claim that the amounts at issue do not constitute interest.

Although the Ninth Circuit ultimately erred in its construction of section 404, it was correct in its characterization of the amounts as "interest . . . on indebtedness"

within the meaning of section 163. Under its deferred compensation agreements, petitioner became indebted to participants to the extent of the compensation for personal services that they had elected to defer; the agreements explicitly provided for accrual of interest on that indebtedness at an objectively determined market rate of interest. *See* App. C at 42a. Those accruals constitute garden variety "interest . . . on indebtedness" falling well within the scope of the deduction afforded by section 163. *See Starker v. United States*, 602 F.2d 1341, 1356 (9th Cir. 1979). All respondent's arguments to the contrary were carefully considered and fully answered by a total of 12 judges below, *see* App. B at 29a-32a; App. C at 61a, 65a-66a, and it is not necessary to beat that dead horse any further here.

Respondent nonetheless asserts that her "contextual interpretation is plainly reasonable, and . . . is entitled to deference from the courts." Br. in Opp. 15. That is pure bootstrapping. Respondent's "contextual interpretation" cannot be found in any regulation under either section 163 or section 404; it is no more than respondent's litigating position in this case. As such, it is entitled to no more deference than any other litigant's position. Moreover, in attempting elsewhere to explain why section 457 explicitly refers to both compensation and interest whereas section 404 refers only to compensation, respondent argues that by 1986 when it enacted section 457 Congress had acquired an "increased analytical sensitivity to implicit interest issues." Br. in Opp. 19 n.7. This argument not only overlooks the fact that section 404 itself was amended in 1986 but also reveals that respondent herself knows full well, notwithstanding her lengthy protestations to the contrary, that the amounts at issue do indeed constitute interest.

c. Turning at last to the real question of statutory construction presented by this case, respondent claims the Ninth Circuit found that "the recognition of immediate deductions [for accrued interest] would be inconsistent

with the terms and purpose of Section 404." Br. in Opp. 16. That is an obvious overstatement. Even on rehearing, the Ninth Circuit expressly, and correctly, recognized that the "plain language" and "literal wording of the statute" or, in respondent's words, "the terms" of section 404, allow the current deduction of accrued interest. App. A at 18a. By its terms, section 404 postpones the deduction only of "compensation," not "interest." In contrast, section 267, which also concerns payments between accrual basis and cash basis taxpayers and whose predecessor was first enacted in the Revenue Act of 1937, Pub. L. No. 377, 50 Stat. 813, 827, always has separately identified both "expenses" and "interest." Even at the time the predecessor of section 404 was enacted, therefore, Congress fully appreciated the difference between "interest" and other expenses such as "compensation" and would not have used the latter term when it meant to refer to the former. *See also* sections 457(a) and 3121 (v)(2)(B) (distinguishing, in the context of deferred compensation plans, between "compensation" or "wages," on one hand, and "income attributable thereto," on the other).

Recognizing the deliberately narrow reach of section 404, respondent's own regulations have long and consistently made clear that the exclusive focus of the statute is on "compensation for personal services actually rendered." Treas. Reg. § 1.404(a)-1(b) (1983). *See also* Temp. Treas. Reg. § 1.404(a)-1T, Q&A-1 (as amended by T.D. 8435, 1992-2 C.B. 324). Indeed, the regulations provide an example of the operation of section 404 which necessarily implies that accrued interest, unlike deferred compensation, is immediately deductible in the year of accrual. *See* App. C at 68a-69a. Ironically, respondent now argues that "[t]here is no warrant for rejecting the Commissioner's reasonable construction of the term 'compensation' in Section 404." Br. in Opp. 20. But the only construction deserving of deference is the one contained in the regulations, not the revisionist position taken in re-

spondent's litigation briefs, and those regulations support petitioner, not respondent.

d. In the end, respondent, like the Ninth Circuit, falls back on the following policy-driven syllogism: in enacting section 404, Congress evidently sought to make qualified plans more attractive than nonqualified plans; to accomplish this result, section 404 requires the employer's deduction for "compensation" to be matched against the employee's recognition of income; extending this "matching principle" to "interest" as well as "compensation" would further enhance the relative attractiveness of qualified plans; to advance the perceived congressional purpose, therefore, one should read the word "compensation" in section 404 (although nowhere else in the entire Internal Revenue Code) to include "interest." *See* Br. in Opp. 16-20; App. A at 10a-13a.

This syllogism confuses judicial responsibility for statutory construction with legislative responsibility for tax policy. The proper role of a court is simply to determine on the basis of the statutory text what Congress actually has done, not to extrapolate from that text to other things Congress could or arguably should have done. In section 404, Congress chose to postpone the deduction only of "compensation"; it chose to leave the treatment of "interest" to section 163. Those choices, and those choices alone, define the tax policy relevant to and controlling in this case. *See Sears, Roebuck and Co. v. Commissioner*, 972 F.2d 858, 868 (7th Cir. 1992) ("Provisions of the Internal Revenue code do not conflict with 'tax policy' . . . . They are tax policy.").

The very different tax policy that the Ninth Circuit adopted instead—a policy that cannot be discerned from either the statutory text or the legislative history—has no grounding in the real world of business either. Both respondent and the Ninth Circuit claim that it is necessary to disallow the current deduction of accrued interest under nonqualified plans to avoid discouraging the estab-

lishment of qualified plans, *see* Br. in Opp. 20, but that is demonstrably wrong. Qualified plans retain numerous tax and other advantages; nonqualified plans, whose effective scope (notwithstanding respondent's suggestion to the contrary, *see* Br. in Opp. 10) is narrowly restricted by the Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1051(a), 1081(a)(3), and 1101 (a)(1) (1995), cannot be substituted willy-nilly for qualified plans. *See* Brief of *Amici Curiae* Connecticut Mutual Life Insurance Company *et al.* 9-10; Brief *Amicus Curiae* of the Chamber of Commerce of the United States of America 6 n.5.

e. Finally, respondent contends that the 1986 amendment to section 404, which the Senate Report aptly described as a mere "clarification," *see* Pet. 19, "forecloses petitioner's contention for all taxable years after 1984." Br. in Opp. 21. Even the Ninth Circuit knew better than that. *See* App. B at 36a. Both before and after the amendment, the word "compensation" stands as the critical term in the statute, and the proper interpretation of that term remains the core focus of statutory construction. *Id.*; *see also* Pet. 19-20. If, as respondent's parting shot implies, petitioner is correct about the proper reading of section 404 prior to 1986, *a fortiori* petitioner also is correct about the proper reading of the virtually identically worded statute that has been in effect since then.

2. *Supermarket HVAC systems constitute "tangible personal property" within the meaning of Section 48.* The regulatory "sole justification" test that distinguishes "tangible personal property" from "structural components" looks centrally at whether the systems are "*required* to meet temperature or humidity requirements which are essential for the operation of other machinery." Treas. Reg. § 1.48-1(e)(2) (1983) (emphasis added). Respondent concedes that "petitioner's retail food stores *require* HVAC systems to keep ambient store temperatures within case manufacturers' specifications." App. D at 79a (emphasis added). *See also* Br. in Opp. 22. In

other words, petitioner must install HVAC systems in its stores, whether or not those systems may also produce collateral benefits. Such systems therefore constitute "tangible personal property" eligible for the investment tax credit and accelerated depreciation.

a. Respondent nevertheless argues that petitioner's HVAC systems fail as a matter of law to pass the regulatory "sole justification" test because they "played an important role in the essential function of ventilating the supermarkets" and "petitioner had installed HVAC systems in most of its stores during the 1950s, well before it was aware of any relationship between those systems and the proper operation of its display cases." Br. in Opp. 23. Those statements are contradicted by the record. As is common in supermarkets, petitioner's stores have fans and other equipment, separate from the HVAC systems, that provide the necessary ventilation. *See* Tr. 584-86, 589. The relationship between air-conditioning and the proper operation of refrigeration equipment, moreover, was known even before supermarkets generally became air-conditioned, Cmr. Ex. EF, and petitioner was forced to install HVAC systems, even in cool climates, because in the absence of air-conditioning and humidity control its refrigerated cases "were continually icing and causing us all sorts of maintenance problems." Tr. 394.

Nonetheless, the Ninth Circuit unquestionably did base its decision upon the presumed collateral benefits of ventilation and customer comfort. App. B at 38a-39a. Respondent, like the Ninth Circuit, treats such collateral benefits as dispositive and irrefutable evidence of multiple motivations for installing an HVAC system, thereby precluding satisfaction of the regulatory "sole justification" test. This implies that no retail food store, and indeed no retail establishment of any kind, will ever be able to satisfy that test. The Tax Court and the Eleventh Circuit disagree. Those courts take note that the regulation itself explains, through an example, that the "sole justification" test may be met notwithstanding the existence of

other collateral benefits; accordingly, those courts hold that the phrase "sole justification" takes its true meaning from the regulatory context and does not exclude the possibility that the installation of HVAC systems might also be justified on other grounds. *See Piggly Wiggly Southern, Inc. v. Commissioner*, 803 F.2d 1572, 1575 (11th Cir. 1986); App. D at 78a-81a.

Respondent does not contend, nor could she, that this case and *Piggly Wiggly* are factually distinguishable. Both courts below knew that they are not. *See* App. B at 40a n.25; App. D at 78a-79a. The disparate outcomes in *Piggly Wiggly* and this case obviously stem, *pace* respondent, from a "conflict among the courts on the applicable legal standard." Br. in Opp. 25; *see also* Brief *Amicus Curiae* of the Food Marketing Institute 9-10. The Eleventh Circuit and the Tax Court understand that Treas. Reg. § 1.48-1(e)(2) calls for a "balancing of the 'sole justification' versus 'incidental benefits.'" *Piggly Wiggly*, 803 F.2d at 1575. In contrast, the Ninth Circuit holds that the very existence of incidental benefits (except, perhaps, when the only beneficiaries are employees) precludes a finding of "sole justification." App. B at 38a-39a.

For all the usual reasons, this conflict between the circuits should be resolved. There is an added reason to do so here. The settled practice of the Tax Court is to adhere to its own precedent "in cases appealable to courts whose views have not yet been expressed." *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 785 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971). As owners of retail food stores continue to contest respondent's position and take their cases to the Tax Court, respondent will be forced to litigate in yet other circuits. However those circuits rule, the existing conflict will be broadened and perpetuated.

b. Indulging in hyperbole, respondent argues that the repeal of the investment tax credit "considerably diminishes" the importance of the regulatory "sole justification"

test. Br. in Opp. 25. The test still controls whether taxpayers may take 200 percent declining balance depreciation over a five-year recovery period or, instead, are restricted to straight-line depreciation over a 39-year period. *Id.; see also* Pet. 14-15. This is a distinction with enormous and continuing revenue implications.

c. Finally, although she necessarily is aware that the legal issue under Treas. Reg. § 1.48-1(e)(2) is precisely the same whether the taxpayer is claiming an investment tax credit or accelerated depreciation, respondent suggests that the Court should decide the issue in a case involving accelerated depreciation. Br. in Opp. 25-26. Petitioner has no quarrel with that. This very case presents the issue in the context of both the investment tax credit and accelerated depreciation. *See* App. D at 76a; *see also* Stip. of Facts ¶¶ 92, 98-133 (stipulating that petitioner will be entitled to accelerated depreciation "should this Court hold that the HVAC systems are 'tangible personal property' " and specifying the amounts of the additional depreciation deductions that will be available). Accordingly, this case is fully appropriate for review even under the standard proposed by respondent.

For the reasons stated here and in the petition for writ of certiorari, the petition should be granted.

Respectfully submitted,

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